

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Chapter 2 Qualified Reporting Groups

Contents:

- 2-1 ENTITIES INCLUDED IN A WATER'S-EDGE COMBINED REPORT
- 2-2 COMPANIES ELIGIBLE FOR INCLUSION IN A CONSOLIDATED 1120
- 2-3 FOREIGN SALES CORPORATIONS AND DOMESTIC
INTERNATIONAL SALES CORPORATIONS
- 2-4 CORPORATIONS WITH TWENTY PERCENT OR MORE ACTIVITY IN
THE UNITED STATES
- 2-5 U.S. INCORPORATED ENTITIES OWNED 50%
- 2-6 EXPORT TRADE CORPORATIONS
- 2-7 CONTROLLED FOREIGN CORPORATIONS WITH SUBPART F
INCOME
- 2-8 ENTITIES WITH INCOME ATTRIBUTABLE TO U.S. SOURCES.
- 2-9 PARTNERSHIPS, JOINT VENTURES AND OTHER HYBRID ENTITIES
- 2-10 AUDIT PROCEDURES

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Section 2.1 Entities Included In A Water's-Edge Combined Report

Contents:

1. Introduction
2. General Rule
3. Criteria For Inclusion
4. Types of Entities to be Included
5. S Corporation Treatment
6. Summary

References:

R&TC §25110

Training Objectives:

At the end of this chapter, the reader will be able to:

1. List the 2 criteria an entity must meet to be included in a water's edge combined report
2. List the 5 types of entities to be included 100% in a water's edge combined report
3. List the 2 types of entities partially included in a water's edge combined report

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

a. Introduction

For income years beginning on or after 1/1/88 taxpayers can elect to restrict the companies included in their combined report to the "water's edge". The purpose of this section is to discuss what entities must be included in a water's-edge combined report and to what extent they are included. The auditor will need to be aware of the different requirements involved in order to discern whether all companies required to be included in the water's-edge combined report have been included, or if an entity was improperly included.

This chapter will provide a list of the entities required to be included in a water's-edge combined report. There will be separate sections for each different type of includible entity. There is also a section at the end of the chapter which lists some possible audit procedures to give consideration to during a water's-edge audit to determine if the different tests are met.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

b. General Rule

Generally, only domestic companies are included in the water's-edge combined report and foreign corporations are excluded. There are seven different types of entities which could be included. Five of them are included 100% and two are only partially included.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

c. Criteria For Inclusion

It is important to remember that the water's-edge rules do not supersede the unitary concept or California's rules for apportionment and allocation of income. Thus, there are two criteria which must be met for an entity to be included in the water's-edge combined report.

The two criteria are:

1. An entity must be unitary.¹ **and**
2. An entity must meet one of the 5 tests for 100% inclusion or one of the two tests for partial inclusion in the water's-edge combined report.²

As stated above, this chapter will address the seven different types of entities to be included in a water's-edge combined report, which is the second criterion for inclusion. To determine the first criterion, if a unitary business relationship exists, consideration should be given to R&TC Section 25101 and the cases decided by the United States Supreme Court, California courts, and the Board of Equalization.

Pursuant to CCR §25110(d)(1)(B), a unitary relationship is determined **first** by reference to the relationship which exists between **all affiliated** banks or corporations, not just those entities which are to be included in the water's-edge group.

Example 1:

Corporation B, a California corporation, is owned 53% by Corporation A, an entity incorporated in a foreign country. Corporation C, a New York corporation, is owned 100% by Corporation A. Corporation A's activities are conducted entirely outside the United States. Due to significant intercompany product flow with Corporation A, Corporation B and Corporation C are each unitary with Corporation A. Although Corporation B and Corporation C have no direct unitary ties with each other, they are considered unitary on a worldwide basis.³ Corporation B elects to determine its income on a water's-edge method and would include Corporation C in its combined report. The income and factors of Corporation A would be excluded due to the water's-edge election.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

d. Types Of Entities To Be Included

The water's-edge statute provides that the following types of "affiliated" entities are included in the water's-edge combined report.⁴

Companies Included 100%

1. Banks or corporations eligible for inclusion in a federal consolidated tax return (IRC §1504), except for corporations making a Section 936 election (possessions corporations) under the IRC.⁵ (NOTE: This criteria for inclusion was repealed effective January 1, 1996).
2. Foreign sales corporations (FSC) and domestic international sales corporations (DISC) under IRC §§921-927.⁶
3. Corporations, regardless of where incorporated, with 20% or more average apportionment factors within the U.S.⁷ This rule does not apply to banks.
4. Banks and corporations incorporated in the U.S. which are owned and controlled more than 50%, except for corporations making an election under IRC §936 of the IRC (possessions corporations).⁸
5. Export trade corporations under IRC §971.⁹

Companies Partially Included

1. Controlled foreign corporations (CFCs) if they have Subpart F income as defined in IRC §952. These companies are included based on the percentage which their Subpart F income bears to their total earnings and profit for the year.¹⁰
2. Foreign nation banks and corporations not meeting any of the requirements to be included 100% are included to the extent that they have income which is "effectively connected" (ECI) or which is treated as being effectively connected with a U.S. trade or business (IRC §882). For income years beginning on or after January 1, 1992, such entities must also include U.S. source non-ECI if the income is business income pursuant to R&TC §25120.¹¹

For income years beginning before January 1, 1994, an "affiliated" entity for purposes of the water's-edge inclusion rules is defined as an entity which is related to the taxpayer because of any of the following:

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

1. It owns directly or indirectly more than 50 percent of the voting stock of the taxpayer.
2. More than 50 percent of its voting stock is owned directly or indirectly by the taxpayer.
3. More than 50 percent of the voting stock of both it and the taxpayer is owned or controlled directly or indirectly by any bank or person (as defined by IRC §7701(a)).¹²

This language effectively provided that ownership or "affiliation" was met only when the stock of a bank or corporation was ultimately held by a single individual or entity because of the statute's reference to ownership by a bank or corporation or any bank or person (i.e. reference was to a single individual or entity). In contrast, for income years beginning before January 1, 1995, R&TC §25105 did not specifically contain a single-entity ownership standard. (The FTB had historically maintained that such a "single-entity" standard was implicit in the language of former §25105. The California courts rejected this interpretation.¹³) In response to these cases, FTB issued Legal Ruling 91-1, which held that unity of ownership could be established not only by a single-entity, but also when a group of shareholders acting in concert jointly controlled a group of corporations.

For purposes of determining unity of ownership for years beginning before January 1, 1995, an affiliated bank or corporation is an entity which is a member of a commonly controlled group of which the taxpayer is also a member. It is not necessary that more than 50 percent of the voting stock of an entity be ultimately owned by another entity or person. It is sufficient if more than 50 percent of the voting stock of an entity is owned by a commonly controlled group of entities. However, ownership is not established through a less than 50 percent owned entity's ownership of stock of other entities.¹⁴ See MATM 3050 for a more detailed discussion of the unity of ownership rules.

Example 1:

Corporation A owns 60% of Corporation B's voting stock and 30% of Corporation C's voting stock. Corporation B owns 30% of Corporation C's voting stock. A, B, and C meet the §25015 ownership standard and the water's-edge affiliation standard. A directly or indirectly owns 60% of C's voting stock.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Example 2:

Corporation A owns 40% of Corporation B's voting stock and 30% of Corporation C's voting stock. Corporation B owns 60% of Corporation C's voting stock. A is not affiliated with B and C because it does not directly or indirectly own more than 50% of their voting stock.

Because of the unique "affiliation" definition contained in the water's-edge statute for income years beginning before January 1, 1994, Legal Ruling 91-1 did *not* apply to determine the members of the water's-edge group. For such years, the water's-edge statute defined "affiliated" banks or corporations subject to inclusion in the water's-edge combined report as those entities meeting a standard of more than 50 percent ownership by a *single* entity. In other words, even though an entity might meet the unity of ownership standard of §25105 (as interpreted by Legal Ruling 91-1), it would only be included in the water's-edge combined report if it met the ownership by a single entity standard set forth in §25110(b)(1).

However, for income years beginning on or after January 1, 1994, R&TC §25110(b)(1) was amended to cross-reference to R&TC §25105. Therefore, the ownership rules of §25105 (including the Legal Ruling 91-1 interpretation of the statute for years beginning before January 1, 1995) applies to determine the water's-edge group effective for income years beginning on or after January 1, 1994. For income years beginning on or after January 1, 1995, the new unity of ownership rules in R&TC §25105 take effect and apply for both worldwide and water's-edge taxpayers (i.e. Legal Ruling 91-1 does not apply. Instead, new R&TC §25105 codifies an over 50 percent "single-entity" standard except for situations involving family ownership and stapled stock).

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

e. S Corporation Treatment

Although an S Corporation cannot have corporate shareholders, the S Corporation rules do allow an S Corporation to own other corporations. R&TC §23801(c) generally precludes S Corporations from being included in a combined report even if the S Corporation has a unitary relationship with other corporations. Regardless, an S Corporation can make a valid water's-edge election. Because an S Corporation is already required to file on a separate company basis, a water's-edge election will not have any effect on the S Corporation's separate filing. The primary reason an S Corporation would elect water's-edge would be to take advantage of the dividend deduction under R&TC §24411 for dividends received from a foreign corporation.

Potential issues involving S Corporations with water's-edge elections

1. **TRANSFER PRICING.** Because the S Corporation files on a separate company basis, the potential for a transfer pricing issue exists. If there is a transfer pricing issue between an S Corporation and an affiliate, an attempt must be made to find a comparable uncontrolled price (CUP) as defined in the IRC §482 regulations. If a CUP does not exist and the arm's-length income cannot be determined by reference to a CUP, then combined reporting may be used by the FTB as a means of properly reflecting the income or loss.¹⁵ If this occurs with an S Corporation which has made a water's-edge election, then the entities subject to inclusion in the combined report are limited to the entities described in R&TC §25110(a). If the S Corporation has not made a water's-edge election, then FTB can require a worldwide combined report as a means to correct the transfer pricing issue.
2. **S CORPORATIONS WITH AFFILIATED FSCs OR CFCs.** An S Corporation can own or have a brother/sister relationship with a FSC or CFC. As discussed above however, the FSC or CFC cannot be combined with the S Corporation. As a result, the S Corporation must file its own California Form 100 on a separate company basis. The FSC or CFC would only file a Form 100 if it were a California taxpayer. With respect to an S Corporation with an affiliated FSC, a potential §482 issue exists if the S Corporation reports the same FSC commission expense for both state and federal purposes. For federal purposes, the S Corporation's deduction for commissions paid to the FSC would be calculated under IRC §922. California does not conform to IRC §922 and the rules under IRC §922 do

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

not comply with the §482 arm's-length standard. Therefore, the S Corporation must re-determine its commission deduction for California purposes as an IRC §162 ordinary and necessary business expense applying the arm's-length standard under IRC §482. If there is a CUP, the CUP will be used to determine the arm's-length commission expense that should have been reported by the S Corporation. If no CUP exists, the FSC should be combined with the S Corporation to resolve the transfer pricing problem. For federal purposes, a CFC is required to report on an arm's-length basis with its affiliates, and is subject to federal §482 audits. Therefore, a state §482 audit is less likely to be needed for a CFC than for a FSC.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

f. Summary

If an entity meets any of the tests listed above and is unitary, it must be included in the water's-edge combined report. An entity which does not meet any of the tests listed above must be excluded even if the unitary requirement is met.¹⁶

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Footnotes

1. R&TC §25110(a)(8)(A)
2. R&TC §25110(a)(1)-(7) & (8)(B)
3. Appeal of Monsanto Co., Calif. Bd. of Equal., 11/6/70
4. R&TC §25110(a)
5. R&TC §25110(a)(1)
6. R&TC §25110(a)(1); formerly §25110(a)(2)
7. R&TC §25110(a)(2); formerly §25110(a)(3)
8. R&TC §25110(a)(3); formerly §25110(a)(4)
9. R&TC §25110(a)(5); formerly §25110(a)(6)
10. R&TC §25110(a)(6); formerly §25110(a)(7)
11. R&TC §25110(a)(4); formerly §25110(a)(5); and CCR §25110(d)(2)(G)
12. R&TC §25110(b)(1)
13. Rainbird Sprinkler Mfg., 229 Cal. App. 3d 784; Hugo Neu-Proler International Sales Corp., 195 Cal. App. 3d 326.
14. CCR §25110(b)(1) and Legal Ruling 91-1.
15. R&TC §23801(d)(1)
16. CCR §25110(d)(1)

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Section 2.2 Companies Eligible For Inclusion In A Consolidated 1120

Contents:

- a. Introduction
- b. General Rule
- c. Federal Requirements
- d. Water's-Edge Application
 - 1. Contiguous Country Corporations
 - 2. Other Audit Issues
- e. §936 Possessions Corporations
- f. Summary

References:

R&TC §25110(a)(1) - (repealed effective January 1, 1996)
IRC §1504
CCR §25110(d)(2)(A)

Training Objectives:

At the end of this lesson the reader will be able to:

- 1. Explain what the determining factor is for inclusion in a water's-edge combined report,
- 2. Explain who can file a consolidated return and what is meant by an affiliated group,
- 3. List the types of includible corporations in a consolidated return,
- 4. List the two foreign incorporated subsidiaries that are includible and how they are eligible for this election,
- 5. List the two areas which must be considered regarding the foreign subsidiaries for the water's-edge combined report, and
- 6. State how possessions corporations are treated for water's-edge purposes.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

a. Introduction

This section will cover the federal requirements of filing a consolidated 1120 and what consideration must be given to these requirements for filing a water's-edge combined report. **Note that this criteria for inclusion in a water's-edge combined report was repealed effective January 1, 1996.**

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

b. General Rule

Any entity which is eligible to be included in a federal consolidated return meets the water's-edge test for inclusion and must be included in the water's-edge group if it is unitary. The determining factor is eligibility regardless of whether or not a federal election to file a consolidated return was made. To determine eligibility one must apply the definitions contained within the IRC and its regulations. These requirements are detailed below. The auditor should note that California's definition of a corporation as provided in R&TC Section 23038 is not applicable.¹

In accordance with IRC §1501, a group of corporations can elect to file a consolidated return for federal purposes. A consolidated return can only be made by an affiliated group of "includible corporations" which must be connected through stock ownership with a common parent. If a group of affiliated corporations elect to file a consolidated return, all includible corporations must file on a consolidated basis. An "includible corporation" is any domestic corporation owned at least 80% by a common parent, and 100% owned Canadian or Mexican corporation formed solely to comply with foreign law.²

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

c. Federal Requirements

An "affiliated group" is defined as one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if two requirements are met:³

1. First, the common parent must own stock possessing at least:
 - a. 80% of total voting power in at least one of the other includible corporations **and**
 - b. Having a value equal to at least 80% of the total value of the stock of such corporation (not including certain non-voting preferred stock).⁴
2. Second, stock meeting the same 80% voting and value test in each of the includible corporations (except the common parent) must be owned directly by one or more other includible corporations.⁵

For purposes of the definition of an affiliated group, the term "stock" does not include certain non-voting stock which is limited and preferred as to dividends.⁶

The group connected by stock ownership is known as a chain. The chain must consist of at least two corporations, a parent corporation and a subsidiary.⁷ Brother/sister groups owned by the same individual shareholders do not qualify.

The affiliated group is generally limited to domestic corporations. In addition, certain corporations organized in contiguous countries solely to comply with the requirements of foreign law may also be included at the election of the taxpayer. A consolidated return must include every domestic corporation which is a member of the affiliated group.⁸

If a corporation ceases to be a member of an affiliated group in a taxable year beginning after December 31, 1984, such corporation or any successor corporation may not be included in any consolidated return filed by the affiliated group (or by another group with the same common parent or its successor) for five years. However, the Secretary may waive the application of this rule to any corporation for any period subject to such conditions as he may prescribe.⁹

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

1. Includible Corporations

Only includible corporations are eligible to make elections to file a consolidated return. The term "includible corporations" is defined as being any corporation except:¹⁰

1. Corporations exempt under IRC §501
2. Insurance companies subject to tax under IRC § 801
3. Foreign corporations (other than certain wholly owned subsidiaries formed in contiguous countries)
4. Corporations which have made an election under IRC § 936 (possessions corporations) for the taxable year.
5. Regulated investment companies and real estate investment trusts subject to tax under subchapter (M) of chapter 1.
6. A DISC as defined in IRC §992(a)(1) or a corporation with post-1984 accumulated DISC income.

2. Foreign Corporations

Foreign corporations are generally not eligible for inclusion in a consolidated return. However, certain Canadian or Mexican corporations wholly owned or controlled (directly or indirectly and exclusive of directors' qualifying shares) by a domestic corporation, may at the option of the domestic corporation be treated as a domestic or includible corporation.¹¹ To be eligible for this election, the foreign corporation must be organized under the laws of Mexico or Canada and be maintained solely for the purpose of complying with the laws of such country as to title and operation of property.¹²

It is not necessary that the foreign corporation was originally organized to comply with foreign law. That is, the foreign corporation need not have been initially formed by the electing parent corporation.¹³ The "sole purpose" test is satisfied even if the reason for foreign incorporation changes from an insufficient purpose for the original incorporation to a new purpose required in order to comply with a new foreign law.¹⁴

The provision permitting a subsidiary formed to comply with foreign law to be treated as a domestic or includible corporation extends the privilege of being included in a U.S. consolidated return to situations where the domestic parent is prohibited by local foreign law from the direct ownership or operation of property in Canada or Mexico.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

The statutory language of IRC Section 1504(d) is unclear as to whether this provision means the property must be both owned "and" operated or owned "or" operated, pursuant to the laws of the contiguous foreign country. The current IRS regulations do not provide a direct answer to this problem. However the regulations applicable to pre-1966 taxable years provide an example:

"For example, if the laws of Canada permit the ownership or operation of specified property, such as a railroad,... then a corporation organized under the laws of Canada to own or operate such will be considered maintained solely for the purpose of complying with the laws of such country as to title and operation of property."¹⁵

The Internal Revenue Service continues to interpret the phrase "as to title and operation of property" to mean "as to title or operation of property."

Another provision of the pre-1966 regulations extended the scope of IRC Section 1504(d) to a subsidiary organized under the laws of any state, province or other political subdivision of Canada or Mexico. The requirements of compliance with the applicable foreign laws include local as well as national laws and encompass existing legislative practice or policy as well as explicit statutory or constitutional provisions.¹⁶

In U.S. Padding Corp. v. Commissioner of Internal Revenue¹⁷, the court ruled on the meaning of (as used in Section 1504(d)) "a corporation organized under the laws of a contiguous foreign country and maintained solely for the purpose of complying with the laws of such country." The court held that Section 1504(d) applies to Canadian subsidiaries maintained due to an existing practice or policy of the foreign country and that U.S. Padding could include its Canadian subsidiary in its consolidated federal 1120 for the years in question. For a detailed explanation of this court decision please see [Exhibit 2.2A](#).

In determining whether a foreign corporation is wholly owned or controlled, consideration must be given to direct and indirect ownership. This is similar to California law.¹⁸

Where a domestic corporation formed a first-tier wholly-owned Mexican subsidiary as well as a second-tier Mexican subsidiary, which was 51% percent owned by the first-tier subsidiary and 49% owned by the domestic parent, solely to comply with Mexican law requiring a particular business to be at least 51% owned by Mexican nationals, the Internal Revenue Service held both corporations were formed solely to comply with Mexican law as to title and operation of property. This was because:

1. The domestic parent owned or controlled, directly or indirectly, 100% of the stock of both corporations, and

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

2. Mexican law prohibits corporations whose stock is not at least 51% owned by Mexican nationals from carrying on certain activities in that country.

Therefore both subsidiaries could be treated as domestic corporations.¹⁹

The election need not be made for the first consolidated return for which the contiguous country corporation qualifies under Section 1504(d). But once the election is made, the Canadian or Mexican corporation is treated as a domestic corporation for all purposes of the Internal Revenue Code. The pre-1966 regulations also provide that the option to treat the foreign corporation as a domestic corporation must be exercised by the due date (including extensions) for filing of the consolidated return for the year and cannot be exercised in a late-filed return or an amended return. Once it is made, the election is binding for future years.²⁰

The position of the Internal Revenue Service is that the exercise of the option to treat a qualified contiguous country corporation as a domestic corporation under Section 1504(d) constitutes a constructive reorganization under IRC Section 368(a)(1)(D).²¹

Under that interpretation, on the first day of the taxable year for which the election is effective, the foreign corporation will be considered to have transferred all of its assets (subject to liabilities) to a successor domestic corporation in exchange for all the stock of the successor domestic corporation, followed by the exchange of that stock with the domestic parent corporation in the complete liquidation of the foreign corporation.

Further, the Service requires compliance with Section 367 to avoid recognition of gain which would otherwise result from such constructive exchanges.²² In such cases, the IRS will require the domestic parent corporation to include in its gross income a deemed cash dividend considered paid as of the beginning of the contiguous country subsidiary's taxable year in which it is first treated as a domestic corporation. The deemed dividend is an amount equal to the "all earnings and profits amount" of that subsidiary as of the preceding day.²³

The amount treated as a dividend will not be eliminated in the consolidated return since it is considered received from the foreign subsidiary. Because the foreign subsidiary was not included in the consolidated return, the deemed dividend under §367 does not qualify for elimination under IRC §243 or Treas. Reg. §1.1502-14. The dividend will be considered foreign source income (and thus will qualify the taxpayer for the deemed paid foreign tax credit) and will increase the electing parent corporation's basis in the subsidiary's stock.²⁴

The Section 367 applies even in the case of a newly formed 100% owned qualified Mexican or Canadian subsidiary as to which the election is made.²⁵

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Even though a valid Section 1504(d) election was made, if the statutory conditions are no longer met, the corporation's status reverts from "domestic" to "foreign". The IRS position is that a constructive reorganization has again taken place under IRC Section 368(a)(1)(D), where a constructive transfer of all the assets from a domestic corporation to a foreign corporation has been made in exchange for all the foreign corporation's stock (and an assumption of all the transferor's liabilities), followed by the exchange of that stock with the domestic parent corporation in the complete liquidation of the domestic corporation.²⁶ This rule is illustrated by the following example, as contained in the regulations..

Example 1:

"Domestic corporation Y previously made a valid election under section 1504(d) to have its wholly owned Canadian subsidiary, C, treated as a domestic corporation. On July 1, 1989, C fails to continue to qualify for the election under section 1504(d). A constructive reorganization described in section 368(a)(1)(D) occurs. The resulting constructive transfer of assets by "domestic" corporation C to Canadian corporation C upon the termination of the election is a transfer of property described in section 367(a)(1).²⁷

These positions of the Service under Section 367 have not yet been tested in court, and may not be sustained by the courts. The Service has taken the position that the election under Section 1504(d) will not terminate when stock of the member owning stock of the contiguous country corporation is spun out of the consolidated group."²⁸

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

d. Water's-Edge Application

1. Contiguous Country Corporations

For purposes of the water's-edge combined report there are a number of things to keep in mind. If there are any Canadian or Mexican subsidiaries which meet the requirements under IRC Section 1504(d), they must be included in the water's-edge combined report even if the election is not made for federal purposes.²⁹ **(But remember, the "eligible for inclusion in a consolidated return" criteria for determining entities required to be included in a water's-edge combined report was repealed effective January 1, 1996.)**

If the foreign corporation is incorporated in Canada, a facts and circumstances audit approach should be used to determine whether the corporation is maintained to comply with Canadian law or whether it could have operated as a branch. U.S. Padding Corp. vs. Commissioner of Internal Revenue³⁰ must be followed.

In Mexico, a Maquiladora Program exists which allows foreign corporations to enter Mexico and establish a factory. If the terms of the Maquiladora Program are met, numerous benefits are allowed, including the transfer of goods into the U.S. without tariffs. If the corporation is incorporated in Mexico as a Maquiladora, then the IRS's position is that the corporation does not qualify to elect under IRC §1504(d). The IRS maintains that the Maquiladora is maintained for a dual purpose, not solely for the purpose of complying with Mexican law. The incorporation is partly to comply with Mexican law and partly to comply with the requirements for Maquiladora status. This position by the IRS has not been tested in court.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

The following guidelines for auditing this issue should be followed for years prior to the repeal of the "eligible for inclusion in a consolidated federal return" criteria.

1. Determine whether the foreign corporation satisfies the greater than 20% average factor test. (See **Section 2.4, Water's-Edge Manual** for detailed discussion.) If so, it is 100% includible; if not, continue.
2. Determine whether the foreign corporation meets the 100% ownership test required by §1504(d). If it fails the ownership test it is not eligible for inclusion in the consolidated return under §1504(d).
3. If the foreign corporation elected IRC §1504(d) for federal purposes,
 - a. If the IRS has addressed the issue, the auditor should accept the IRS audit results unless the IRS determination was clearly erroneous.
 - b. If the IRS is not auditing and the issue is material, the auditor should require the taxpayer to substantiate why it qualified to elect IRC §1504(d).
4. If the foreign corporation did not elect IRC §1504(d),
 - a. The auditor should evaluate the materiality of the issue. In determining whether or not the issue is material, the auditor should consider the potential effects of intercompany eliminations, dividends, foreign investment interest offset, and the regular interest offset. If the auditor will have to conduct a unitary audit in order to include the foreign corporation in the water's-edge group, then the complexity of the unitary audit must be factored into the materiality decision.
 - b. If the issue is material, the auditor should gather specific facts regarding the foreign corporation's incorporation, its business activities, the amount of presence in the foreign country, etc.
 - c. This is a difficult issue that may require significant audit resources. The International Specialist is available to provide assistance to the auditor in evaluating the preliminary facts and developing a plan for completing the examination of the contiguous country issue.

2. Other Audit Issues

- California did not adopt IRC Section 1504(d). Since the application of IRC Sections 367 and 368 are predicated on the existence of IRC §1504(d), for

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

California purposes, no constructive reorganization is deemed to have occurred. As a result, if any Canadian or Mexican subsidiaries are included in the federal consolidated return, the deemed cash dividend required to be included for federal purposes in accordance with IRC Section 367, must be eliminated as a state adjustment to arrive at net income for state purposes. If these foreign subsidiaries have not been included for federal purposes, this adjustment is not necessary.

- If a profitable foreign corporation was partially included in the original water's-edge combined report (such as a controlled foreign corporation (CFC) with Subpart F income) and it is determined at audit that the entity meets the IRC §1504(d) standard, the net audit adjustments would increase the amounts that were reported to include 100% of the taxable income and apportionment factors.
- If the auditor combines a foreign corporation, any dividend income received by the water'-edge group from the foreign corporation that was included in income on the original return would be eligible for intercompany elimination under §25106 to the extent the dividend is paid from E&P considered in a combined report. See Chapter 13(c), Water's-Edge Manual for a discussion of the ordering rules for determining the source of a dividend distribution.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

e. §936 Possessions Corporations

Possessions corporations are not includible in a federal consolidated return. Consistent with this, possessions corporations are excluded from the water's-edge combined report under this test. It should also be noted that the federal rules regarding the profit-splitting and cost-sharing methods under the IRC section 936(h), have not been enacted in California. As a result the arm's length standard will be used for all transactions between the possessions corporation and its U.S. affiliates.³¹ See Chapter 7, Water's-Edge Manual for a detailed discussion of possessions corporations.

See **Section 2.4, Water's-Edge Manual** regarding application of the 20% U.S. activity test to foreign and possessions corporations.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

f. Summary

Any entity eligible to be included in a federal consolidated return meets the test for inclusion under R&TC §25111(a)(1), and if unitary must be fully included in the water's-edge combined report. The determining factor for inclusion in the water's-edge return is eligibility, whether or not a federal election was actually made.

Basically an "includible corporation" for federal purposes is any domestic corporation (except those excluded by statute), and any 100% owned Canadian or Mexican corporation organized solely to comply with the requirements of foreign law. A consolidated return must include every domestic corporation which is a member of an affiliated group.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Footnotes

1. CCR 25110(d)(2)(A)
2. Federal Income Taxation of Corporations Filing Consolidated Returns, Lerner, Antes, Rosen, and Finklestein, 1994, §2.02[1], §2.02[4] and IRC §1504(d)
3. IRC §1504(a)
4. IRC §1504(a)(1)(B)(i) and IRC §1504(a)(2)(A) & (B)
5. IRC §1504(a)(1)(B)(ii) and IRC §1504(a)(2)(A) & (B)
6. IRC §1504(a)(4)
7. IRC §1504(a) and Treas. Reg. §1.1502-75(d)(1)
8. Rev. Rul. 56-559, 1956-2 C.B. 595 (IRS)
9. IRC §1504(a)(3)
10. IRC §1504(b) & §1504(d)
11. IRC §1504(d)
12. IRC §1504(d)
13. Private Letter Ruling 7942001 (April 25, 1979) (IRS)
14. Private Letter Ruling 8217035 (January 27, 1982) (IRS) Private Letter Ruling 8425016 (March 13, 1984) (IRS)
15. Treas. Reg. §1.1502-2A(b)(3)(i)
16. Treas. Reg. §1.1502-2A(b)(3)(i)
17. U.S. Padding Corp. v. Commissioner of Internal Revenue, 88 T.C. 177 (1987), aff'd 865 F.2d 750, 89-1 USTC 9573, 63 AFTR2d 89-511 (6th Cir. 1989)
18. R&TC 25105
19. Rev. Rul. 69-182, 1969-1 C.B. 218 (IRS) Private Letter Ruling 8408005 (November 13, 1983) (IRS)
20. Treas. Reg. §1.1502-2A(b)(3)(ii)
21. Temp. Treas. Reg. §7.367(b)-1(a)
22. Temp. Treas. Reg. §7.367(b)-1(b)
23. Temp. Treas. Reg. §7.367(b)-7(c)(2), 42 Fed. Reg. 65152, 65150, (1977); Private Letter Ruling 7721018 (February 24, 1977) (IRS); and Private Letter Ruling 7822009 (March 1, 1978) (IRS)
24. IRC §902, Temp. Treas. Reg. §7.367(b)-3(f), 42 Fed. Reg. 65152, 65159, (1977); IRC §358(a)(1)(B)
25. Rev. Rul. 68-43, 1968-1 C.B. (IRS); Private Letter Ruling 8319014 (February 7, 1983) (IRS)
26. Temp. Treas. Reg. §1.367(a) - 1T(c)(5); Private Letter Ruling 8453022 (September 28, 1984) (IRS); Private Letter Ruling 8522090 (March 7, 1985) (IRS)
27. Temp. Treas. Reg. §1.367(a) - 1T(c)(5)
28. Private Letter Ruling 8742017 (July 16, 1987) (IRS)
29. CCR §25110(d)(2)(A)
30. U.S. Padding Corp. v. Commissioner of Internal Revenue, 88 T.C. 177

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

-
- (1987), aff'd 865 F.2d 750, 89-1 USTC 9573, 63 AFTR2d 89-511 (6th Cir. 1989)
31. R&TC §24725 & §25114

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Section 2.3 Foreign Sales Corporations And Domestic International Sales Corporations

Contents :

- a. Introduction
- b. General Rule
- c. Federal Requirements
- d. Water's-edge Application
- e. Summary

References:

R&TC §25110(a)(1) -- (formerly §25110(a)(2))
CCR §25110(d)(2)(B)

Training Objectives:

At the end of this lesson, the reader will be able to:

- 1. List the 6 requirements a corporation must meet to qualify as a FSC
- 2. Define the term "small FSC"
- 3. List the 5 requirements a corporation must meet to qualify as a DISC
- 4. Explain the implication a FSC or DISC has in a water's-edge combined report

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

a. Introduction

This chapter will cover the basic federal requirements and the rules for the inclusion of foreign sales corporations (FSC) and domestic international sales corporations (DISC) in the water's-edge group.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

b. General Rule

Any corporation which meets the federal requirements to qualify as a domestic international sales corporation (DISC) in accordance with Section 992 of the Internal Revenue Code or a foreign sales corporation (FSC) in accordance with Section 922 of the Internal Revenue Code, and is unitary, must be included in the water's-edge combined report. A corporation which has filed a federal election to be treated as a FSC but does not qualify, shall not be included in the water's-edge combined report under this test.¹

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

c. Federal Requirements

In 1971 Congress enacted the DISC provisions to allow deferral of export income and to mitigate some of the tax disadvantage of domestic corporations in the export market. Partly in response to arguments by the European Economic Community (EEC) and other countries that the DISC provisions constituted an illegal export subsidy under the General Agreement on Tariffs and Trades (GATT), Congress, in 1984, enacted the Foreign Sales Corporation (FSC) provisions. The FSC provisions were intended to mirror the DISC provisions. The primary distinction between the two provisions is that DISCs are U.S. corporations and FSCs are foreign corporations. Although the FSC provisions were generally designed to replace the DISC provisions, the DISC provisions are still available in modified form.

There are now three types of corporate structures available to provide relief from federal taxation of earnings from export corporations:

- FSC
- small FSC
- Interest Charge DISC

To qualify as a foreign sales corporation, a corporation must meet the following six requirements:²

1. it must be created or organized under the laws of a foreign country or possession
2. it may not have more than 25 shareholders at any time
3. it may not have any preferred stock outstanding at any time
4. it must maintain an office located outside the United States with a permanent set of books;
5. it must have at least one director who does not reside in the United States; and
6. it may not be a member of a controlled group which includes a DISC

In addition, the FSC must make an election which is in effect for the taxable year to be treated as a FSC.³

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Small FSCs

A small FSC is a FSC with respect to any taxable year if the corporation:⁴

1. has made an election which is in effect for the taxable year to be treated as a small FSC, and
2. is not a member, at any time during the taxable year, of a controlled group of corporations which includes an FSC unless the other FSC has also made a small FSC election which is in effect for the year.

DISCs

A corporation will qualify as a DISC for a taxable year if it is a domestic corporation organized under the laws of any State and satisfies the following requirements for the taxable year:⁵

1. 95% or more of the corporation's gross receipts consists of qualified export receipts
2. the adjusted basis of the qualified export assets of the corporation at the close of the taxable year equals or exceeds 95% of the sum of the adjusted basis of all the assets of the corporation at the close of the taxable year.
3. the corporation does not have more than one class of stock and the par or stated value of its outstanding stock is at least \$2,500 on each day of the taxable year.
4. the corporation has made an election to be treated as a DISC and such election is in effect for the taxable year; and
5. the corporation is not a member of any controlled group of which a FSC is a member.

Former Disc

During water's-edge years, there could also be a corporation which is a "former Disc". The term "former DISC" is defined as a corporation which is not a DISC for the year, but was one in a preceding taxable year.

The former DISC must have undistributed previously taxed income or accumulated DISC income at the beginning of the taxable year in which it is not a DISC.⁶ The former DISCs are included in the water's-edge group.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

d. Water's-Edge Application

The inclusion of FSCs, DISCs or former DISCs in the water's-edge combined report does not present different implications than those which already exist with respect to their inclusion in a worldwide combined report.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

e. *Summary*

Any U.S. corporation which meets the requirements to qualify as a domestic international sales corporation (DISC) in accordance with IRC Section 992 and any foreign corporation which meets the requirements to qualify as a foreign sales corporation (FSC) in accordance with IRC Section 922, and which are unitary, must be wholly included in the water's-edge combined report.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Footnotes

1. CCR §25110(d)(2)(B)
2. IRC §922(a)
3. IRC §927(f)
4. IRC §922(b)
5. IRC §992(a)(1)
6. IRC §992(a)(3) & Treas. Reg. §1.992-1(h)

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Section 2.4 Corporations With Twenty Percent Or More Activity In The United States

Contents:

- a. Introduction
- b. General Rule
- c. Water's-edge Application
 - 1. Application of Treaty Provisions
 - 2. Free Trade Zones
 - 3. Rules to Determine 20% Test
 - 4. Computing the 20% Amount
- d. Possessions Corporations
- e. Audit Techniques
- f. Summary

Reference:

R&TC §25110(a)(2) -- (formerly §25110(a)(3))
CCR §25110(d)(2)(C)

Training Objectives:

At the end of this lesson the reader will be able to:

- 1. List the factors utilized to determine if a corporation has at least 20% activity in the United States.
- 2. Explain the special rules which apply in arriving at the percentage for each factor.
- 3. Describe how possessions corporations are treated under this test.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

a. Introduction

This section will cover how to determine if an entity, whether foreign or domestic, has 20% or more activity in the United States; and how it will be included in the water's-edge combined report.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

b. General Rule

Any corporation, whether organized in the United States or a foreign country, must be included 100% in the water's-edge combined report if the average of its property, payroll and sales factors within the United States is 20% or more.¹

This rule applies to possessions corporations excluded under other water's-edge provisions. This rule does not apply to banks.

As discussed in Section 2.1, Water's-Edge Manual, R&TC §23801(c) precludes S Corporations from being included in a combined report unless there is a transfer pricing issue that cannot be resolved by use of a comparable uncontrolled price. See Section 2.1, Water's-Edge Manual for a more detailed discussion of this issue.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

c. *Water's-Edge Application*

In applying the 20-percent test for inclusion, the actual factor percentage calculated for each individual state should be used, if it exists, using the apportionment factor rules of that state.² If a corporation on a worldwide basis does not have one or more of the factors of property, payroll, or sales, that factor will be disregarded in computing the average of its factors within the U.S.³ If a state does not have a statute providing for an income tax or did not use a particular apportionment factor in its apportionment formula, the regulations provide for the utilization of California's rules for computing the factor.

For **interstate** commerce to be taxable by a state, there must be constitutional nexus to tax and the activity must exceed the standard set forth in Public Law 86-272.⁴ Commerce between the U.S. and Puerto Rico is considered interstate commerce. See Section 2.4(d), Water's-Edge Manual for further discussion of possession corporations.

For **foreign** commerce to be taxable by a state, there must be constitutional nexus in order to assign the business activity to that state. Public Law 86-272 does not apply to foreign commerce. (Foreign commerce means shipments between the U.S. and a foreign country.) As long as the entity engaging in foreign commerce has some minimum level of contact (i.e., constitutional nexus) with the destination state, the sales would be considered for purposes of the 20% test. It is not relevant that the taxpayer does not file a return in the destination state, or that the state chooses not to tax the activities in question.⁵ What is relevant is whether the state could tax the activities if it chose to do so. Thus, sales of tangible personal property into the U.S. by a foreign corporation will be includible in the sales factor if the foreign corporation has nexus in the state to which the goods were shipped. Nexus is determined on a state by state basis.

The U.S. Supreme Court has held that the following types of contact with a state are sufficient to constitute nexus (Scripto v. Carson (1960) 362 US. 207):

- a. Continuous local solicitation on the taxpayer's behalf in the state by employees or unrelated 3rd-parties (wholesalers, jobbers, or "salesmen")
- b. Regular, systematic displaying of its products by catalogs, samples or the like.

Physical presence within a jurisdiction has long been recognized as a requirement for nexus, although the trend in recent court decisions appears to be a de-emphasis of the physical presence requirements in recognition of the changing business environment. Courts in other states have found nexus to be

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

present based upon a substantial economic presence within a state so long as the level of physical presence was "more than a slightest presence."⁶

For further discussion of nexus and P.L. 86-272, see MATM 1100 - MATM 1240.

1. Application Of Treaty Provisions

If the taxpayer is filing a federal 1120F, the auditor should review the return to see if the foreign corporation is claiming a treaty-based exemption (Federal Form 1120F, Question W). For purposes of the 20% U.S. activity test, it does not matter that the corporation is claiming a immunity for federal tax purposes. Tax treaty provisions, including the permanent establishment rules, generally do not apply to the states. These rules are not applicable for purposes of determining if a foreign entity has a taxable presence in a particular state. For purposes of determining taxable nexus, the states are bound only by the laws and constitution of the U.S. Note, however, if the taxpayer is claiming a treaty exemption, it provides an indication that the foreign corporation may have a presence in the U.S. since it probably has property, payroll or sales in the U.S.

2. Free Trade Zones

The auditor might want to determine if the corporation is operating in any Free Trade Zones (also called Foreign Trade Zones). Corporations can warehouse, assemble and manufacture goods within a Free Trade Zone. Such goods are exempt from U.S. customs duties and federal excise taxes until sent from the zone. The income derived from the sale of goods in a free trade zone warehouse within the U.S. is not exempt from federal income tax under the IRC (see Rev. Rul. 76-161), but may be exempt by treaty. As discussed above, the federal treaty immunity rules are not relevant for purposes of the 20% activity test.

As a general rule, storing property within a state will be sufficient to establish taxable nexus. The value of such property is then included in the numerator of the property factor of the taxpayer's apportionment formula for that state. Note that if inventory is simply warehoused in a state for a brief period of time awaiting further transportation of the goods to the ultimate destination (e.g the goods pass through the state as part of a "stream of commerce"), generally neither the inventory nor the sale would not be assignable to that state. Alternatively, if the purchaser takes possession (or constructive possession through an agent or bailee) so that the goods leave the stream of commerce within a state, such as for inspection or minor assembly work, the inventory and the sale are assignable

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

to that state. For a further discussion of this issue, see Appeal of Mazda Motors, Inc., 94- SBE-009, November 29, 1994.⁷

3. Rules To Determine 20% Test

To arrive at the percentage for each factor the following rules apply:

1. Determine the percentage for each factor in each state in which a corporation is taxable. The determination of whether the corporation is taxable in a state is based on the constitution and laws of the U.S.⁸ In other words, factors are assigned to a state as long as the state has jurisdiction to tax regardless of whether the state, in fact, taxes the corporation. If the state assesses a tax on or according to income, the rules of that state apply. For example, the rules of that state may include property in the factor at net book value instead of original cost.⁹ Note, however, that double weighting of a sales factor by any state is not taken into consideration in determining if the entity has a 20 percent or more average U.S. apportionment factor. Double weighting does not change the sales factor amount, it simply gives greater weight to that factor for purposes of determining the amount of income apportioned to that particular state.¹⁰
2. For any state which does not impose a tax on, or according to income, or which does not assign income utilizing an apportionment formula consisting of property, payroll and sales, the corporation must compute the property, payroll and sales of that state utilizing the California apportionment rules for the factor(s) not utilized by that state.¹¹
3. If the property, payroll, or sales in an state are not defined in a substantially uniform manner¹², the taxpayer may elect (but is not required) to compute each factor in accordance with the California apportionment rules.
4. To compute the sales factor:
 - a. Any sales made by the corporation to a member of the water's-edge combined report group are not included in either the numerator or denominator of the factor. In addition, no item of property, payroll, or sales shall be assigned in total to more than one state.¹³
 - b. Throwback sales are to be included in calculating the sales factor to the extent required under the applicable state law.¹⁴ Remember: If these sales are made to an affiliate in the water's-edge combined report group they would be eliminated from the computation.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

-
5. The 20% or greater U.S. activity test is an annual test. Thus, a corporation may be eligible for inclusion in one income year but not qualify in another year. Also, the test is computed separately for each individual corporate entity, based on its activities in the U.S. (i.e. The Finnigan decision has no application in determining whether a particular entity has a 20 percent or greater U.S. apportionment factor. Finnigan does *not* assign the activity or factor to the "non-taxpayer." On a separate company basis, the entity does not have a factor in the state if its activities are immune from taxation because it does not have nexus in the state.)

4. Computing The 20% Amount

Due to the different rules in each state, the factor percentage must be determined on a state by state basis; then totalled to determine if it is 20% or greater.

Example 1:

ABC Ltd. (a foreign corporation) has worldwide property of \$1 million, worldwide payroll of \$500,000, and worldwide sales (excluding intercompany sales) of \$420,000. ABC Ltd. has constitutional nexus in each state to which it ships goods. It has no property or payroll in the U.S. Its 3rd-party sales are as follows:

3 rd Party Sales To:	
Pennsylvania	\$125,000
New Mexico	30,000
California	100,000
Foreign	165,000
Total 3 rd Party Sales	<u>\$420,000</u>

The factors in each state, calculated using the rules of the respective states, are as follows:

	U.S.	Worldwide	%
Pennsylvania			
Property	\$ 0	\$1,000,000	0
Payroll	0	500,000	0
Sales	125,000	420,000	29.7610%
New Mexico			

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Property	\$ 0	\$1,000,000	0
Payroll	0	500,000	0
Sales	30,000	420,000	7.1429%
California			
Property	\$ 0	\$1,000,000	0
Payroll	0	500,000	0
Sales	100,000	420,000	23.8095%

The average U.S. apportionment factor is calculated as follows:

	Property %	Payroll %	Sales
Pennsylvania	0	0	20.7619%
New Mexico	0	0	7.1429%
California	0	0	<u>23.8095%</u>
Total	0	0	60.7143%
Average (/3)			<u>20.2381%</u>

Because ABC Ltd.'s average of its property, payroll and sales factors in the U.S. is 20% or more, 100% of its factors and net income will be included in the water's-edge combined report.

Note that none of the factors were double-weighted even though state statutes may require it. This is because the double-weighting is done after the factor is determined and it not part of the factor computation itself.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

d. Possessions Corporations

If a possessions corporation meets the test of having 20% or greater activity in the United States, then it must be included in the water's-edge combined notwithstanding its specific exclusion under the "eligibility for inclusion in a consolidated 1120" test and the "U.S. corporations owned greater than 50%" test.¹⁵

Although Puerto Rico is not one of the 50 states, it has a unique status that causes commerce between the United States and Puerto Rico to be protected under P.L. 86-272.¹⁶ Therefore, a corporation's business activities within a state must exceed solicitation of sales of tangible personal property before its sales from Puerto Rico into the United States may be considered United States sales for purposes of the 20% test.

When determining whether a possessions corporation has 20% or greater activity in the U.S., remember that intercompany sales to affiliates already included in the water's-edge group must be excluded from the computation.

Example 2:

Acme P.R. is a possessions corporation which assembles broomsticks. Acme P.R. sells all of its finished product to distributors in the United States. 1000 of the broomsticks are sold to Acme U.S., its parent corporation. 200 broomsticks are sold to Hazel's Rent-a-Broom located in California. This example assumes that Acme P.R.'s activities in California exceed solicitation of sales. What is Acme P.R.'s sales factor in the United States?

Answer 100%; assuming all sales are at the same price, the answer is computed as follows:

Total Sales	1200 units
Less Intercompany Sales	<u>1000 units</u>
Net Sales	200 units
U.S. Sales/Net Sales	200/200 = 100%

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

If there were no payroll or property factors in the U.S., ACME P.R.'s average U.S. factors would be 33%, and would meet the 20% test. Therefore, ACME P.R. would be wholly included in the water's-edge combined report.

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

e. *Audit Techniques*

When there is a geographical breakdown of property and sales in the annual report, the auditor can request detail on an entity by entity basis for use in determining if the taxpayer has sufficient activity within the U.S. to *potentially* meet the 20% U.S. activity test. Remember, however, before any sales can be assigned to a state the entity must be taxable in the state under the laws and constitution of the U.S. Therefore, once you have identified that there is sufficient activity within the U.S. to give rise to a 20% or greater U.S. factor, you must still determine if the entity has sufficient presence in the states to be able to assign the factors to the U.S. This will require a detailed examination of the entity's activities in the U.S. (including the activities of an agent on their behalf) to determine if the entity has taxable nexus. (In the case of commerce between the United States and Puerto Rico, the determination will be whether the entity's activities exceed solicitation of sales protected under P.L. 86-272.) Because a nexus audit can be very time-consuming, materiality should be considered in determining whether to pursue this issue.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

f. Summary

Any domestic or foreign corporation must be wholly included in the water's-edge combined report if the average of its property, payroll and sales within the United States is 20% or more. To determine if a corporation has 20% or greater activity in the United States, sum the percentage calculated for each factor for each state using their rules, and then divide by three.

This is an annual test which must be done separately for each income year and for each affiliate.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Footnotes

1. CCR §25110(d)(2)(C)(i)
2. CCR §25110(d)(2)(C)(iii)
3. CCR §25110(d)(2)(C)(ii)
4. R&TC §25110(b)(3)
5. CCR §25110(d)(2)(C)(iii)(I)
6. For example, see the New York Court of Appeals cases of Orvis Company, Inc. and Vermont Information Processing, Inc. (1995) 86 N.Y.2d 954.
7. See also Legal Ruling 95-3, July 20, 1995; McDonnell Douglas v. Franchise Tax Board (1994) 26 Cal. App. 4th 1789.
8. R&TC §25110(b)(3)
9. See 5. Supra.
10. Legal Ruling 95-5, October 13, 1995
11. CCR §25110(d)(2)(C)(iii)(II)
12. CCR §25110(d)(2)(C)(iii)(III). The regulations, as written, do not say uniform to what. They mean uniform with each other (e.g. if Kansas and New Jersey have different rules for the same factor, the taxpayer can elect to use California rules to determine the factor percentage in those states.)
13. CCR §25110(d)(2)(C)(iii)(IV) & (V)
14. CCR §25110(d)(2)(C)(iii)
15. CCR §25110(d)(1)
16. Legal Ruling 99-1, January 7, 1999

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Section 2.5 U.S. Incorporated Entities Owned 50%

Contents:

- a. Introduction
- b. General Rule
- c. Summary

References:

R&TC §25110(a)(3) -- (formerly §25110(a)(4))
CCR §25110(d)(2)(D)

Training Objectives:

At the end of this lesson, the reader will be able to:

- a. State when a domestic corporation owned greater than 50% is included in a water's-edge combined report.
- b. State the purpose of this test.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

a. Introduction

This section will cover when U.S. incorporated entities owned greater than 50% are included in the water's-edge combined report.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

b. General Rule

Any corporation or bank incorporated in the United States that is owned greater than 50%, directly or indirectly by the same interests must be included in the water's-edge combined report if it is unitary, regardless of where its property, payroll or sales are located. This rule does not apply to a corporation making an election under Sections 931 to 936 of the Internal Revenue Code (a possessions corporation).¹

This section was originally intended to ensure the inclusion in the combined report of U.S. incorporated entities which were not eligible for inclusion in a consolidated federal 1120 due to the federal 80% ownership requirement, but would meet the ownership requirement for inclusion in the California combined report. Note, however, that the water's-edge provisions were amended effective January 1, 1996 to repeal R&TC §25110(a)(1). As a result of this amendment, eligibility for inclusion in a consolidated federal return is no longer a criteria for inclusion in the water's-edge combined report. (The effect of this amendment is to exclude contiguous country corporations from the combined report if the sole basis for their inclusion would be that they meet the eligibility for inclusion in a consolidated federal return. Such entities must still be included in a water's-edge combined report if they meet one of the other tests for inclusion (e.g. Subpart F income, 20 percent U.S. activity, etc.)).

As a result of the repeal of the tie-in to the federal consolidated return, §25110(a)(3) is now the primary test causing U.S. incorporated entities to be included in the water's-edge combined report.

With the exception of possessions corporations, all unitary U.S. incorporated affiliates are required to be included in a water's-edge combined report. No provision was made to exclude the so-called 80/20 corporations. (i.e., U.S. corporations with 80% or more of their activities conducted outside the U.S.) Therefore, even a U.S. corporation (other than a possessions corporation) with all, or substantially all of its activities outside the United States will be included in a water's-edge combined report in full under either this test.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

c. *Summary*

Any U.S. incorporated entity (other than a possessions corporation) which is owned greater than 50% directly or indirectly by the same interests, and which is unitary, must be wholly included in the water's-edge combined report.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Footnotes

1. CCR §25110(d)(2)(D)

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Section 2.6 Export Trade Corporations

Contents:

- a. Introduction
- b. General Rule
- c. Federal Requirements
- d. Water's-edge Application
- e. Summary

References:

R&TC §25110(a)(5) -- (formerly §25110(a)(6))
CCR §25110(d)(2)(E)
IRC §971

Training Objectives:

At the end of this lesson, the reader will be able to:

- 1. Explain what constitutes an export trade export corporation for federal purposes
- 2. List the 4 classes of export trade income
- 3. Describe the qualifying dates of incorporation for an export trade corporation
- 4. Explain the implications an export trade corporation has in a water's-edge combined report

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

a. Introduction

This lesson will cover the basic federal requirements for a CFC to qualify as an export trade corporation and the implications on a water's-edge combined report.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

b. General Rule

Any unitary corporation meeting the requirements of an export trade corporation, as defined within Section 971 of the Internal Revenue Code must be included in the water's-edge combined report.¹

The export trade rules are in Subpart G of the Internal Revenue Code. The subpart centers on Section 971 (export trade corporations provide relief from taxation under the IRC's Subpart F rules). Under these rules, a controlled foreign corporation's foreign base income as defined in Subpart F excludes those amounts considered export trade income for its taxable year.

A controlled foreign corporation (CFC) is a foreign corporation of which more than 50% of the total combined voting stock is owned by a U.S. shareholder.² For a detailed explanation of what constitutes a CFC please refer to Chapter 9, Water's-Edge Manual. Legislative history indicates that Subpart G was intended to maintain the tax advantages for controlled foreign corporations engaged in selling United States products abroad, as opposed to those operating principally as a means of exporting capital to tax haven countries.³

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

c. Federal Requirements

No CFC may qualify as an export trade corporation for any taxable year beginning after October 31, 1971, unless it qualified as an export trade corporation for any other taxable year beginning before that date.

Where a CFC otherwise fails to qualify as an export trade corporation for a period of any three consecutive taxable years beginning after October 31, 1971, it may not qualify as an export trade corporation beginning after that three-year period. The Internal Revenue Service ruled that a corporation organized after October 31, 1971, that acquired an export trade corporation in a reorganization, does not itself attain the status of export trade corporation, and does not qualify for treatment under Subpart G.⁴

In order for a CFC to be considered an export trade corporation, it must derive 90% or more of its income for the three-year period immediately preceding the close of its taxable year from sources outside the U.S.⁵ The sources of gross income of the CFC are determined under Sections 861 through 864 of the IRC.⁶

75% or more of the CFC's gross income for the foregoing three year period must have been derived from export trade income.⁷

Subpart G defines export trade income to comprise the CFC's gross income from four classes of transactions, each as reduced by allocable expenses, taxes, or other deductions.⁸ The four classes of export trade income are as follows:

1. Income of a CFC derived from the sale of export property to an unrelated person for use, consumption, or disposition outside the United States.⁹
2. Income derived from commissions, fees, compensation, or other income, from commercial, industrial, financial, technical, scientific, managerial, engineering, architectural, skilled, or other services, performed in connection with the use by an unrelated person outside the United States of patents, copyrights, secret processes and formulae, goodwill, trademarks, trade brands, franchises, and similar property, acquired or developed and owned by the manufacturer, producer, grower, or extractor of export property, in respect of which the export trade corporation earns export trade income from sales, installation, or maintenance.¹⁰

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

-
3. Income derived from commissions, fees, rentals, or other compensation or income attributable to the use of export trade property by an unrelated person, or attributable to the use of export property in the rendition of technical, scientific, or engineering services to an unrelated person.¹¹
 4. Interest income received on certain export trade assets, evidences of indebtedness executed by unrelated persons in connection with payment for purchases of export property for use, consumption, or disposition outside the United States or in connection with payments for the services described above.¹²

The CFC's export trade income equals the gross amounts of income from the four categories above, each as reduced by those expenses, taxes, or other deductions properly allocable to such categories of export trade income or to particular items to which they directly relate.

Those expenses, taxes, and other deductions that cannot definitely be allocated to some item or category of export trade income are to be ratably apportioned among all the items or categories of gross export trade. No expense, tax, or other deduction, however, is to be allocated to an item or category to which it clearly does not apply. Also, no deduction allowable to a controlled foreign corporation under I.R.C. Section 882(c), on deductions for amounts connected with income that is effectively connected with the conduct of trade or business within the U.S. and for charitable contributions is to be taken into account.¹³

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

d. Water's-Edge Application

Any CFC which meets the requirements of an export trade corporation and which is unitary must be wholly included in the water's-edge combined report.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

e. *Summary*

Subpart G of section 971 defines the export trade income to comprise the controlled foreign corporation's gross income from four classes of transactions, each as reduced by allocable expenses, taxes or other deductions. No controlled foreign corporation may qualify as an export trade corporation for any taxable year beginning after October 31, 1971, unless it qualified as one for any other taxable year beginning before that date. For federal purposes, export trade corporations are virtually non-existent. As a result one would not expect to find many of them during the course of a water's-edge audit.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Footnotes

1. CCR §25110(d)(2)(E)
2. Treas. Reg. §1.957-1(a)
3. IRC §971(a)(3)
4. Rev. Rul. 76-126, 1976-1 C.B. 209
5. Treas. Reg. §19.71(a)(1)(A)(i) and Treas. Reg. §971-1(a)(2)
6. Treas. Reg. §1.971-1(1)(a)(4)
7. IRC §971(a)(1)(B) and Treas. Reg. §1.971-1(a)(2) & Treas. Reg. §1.971-1(a)(3)(ii)(a)
8. IRC §971(b)
9. IRC §971(e) & (f)
10. IRC §971(b)(2)
11. IRC §971(b)(3)
12. IRC §971(b)(4)
13. Treas. Reg. §1.971-1(b)(1)(viii)

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Section 2.7 Controlled Foreign Corporations With Subpart F Income

Contents:

- a. Introduction
- b. General Rule
- c. Subpart F Income
- d. Water's-edge Application
- e. Summary

References:

R&TC §25110(a)(6) -- (formerly §25110(a)(7))
CCR §25110(d)(2)(F)

Training Objectives:

At the end of this lesson, the reader will be able to:

- 1. Explain how a controlled foreign corporation (CFC) with Subpart F Income is included in the Water's-edge combined report.
- 2. State the limitations for a Water's-edge combined report if the CFC had no earnings and profits for the year.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

a. Introduction

The last section discussed the treatment in the water's-edge combined report of a CFC which was considered an export trade corporation. This section will cover how a CFC with Subpart F income is included in the water's-edge combined report.

For a more detailed explanation of the federal definition of a CFC and Subpart F income, please refer to **Chapter 9, Water's-Edge Manual**.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

b. General Rule

Any CFC as defined in Section 957 of the Internal Revenue Code (IRC) with Subpart F Income as defined in Section 952 of the IRC is partially included in the water's-edge combined report. Generally, a CFC is an entity which is organized in a foreign country and which is owned greater than 50% by United States shareholders.¹

Remember, a CFC generally cannot be partially included in a combined report with an S Corporation because of the provisions of R&TC Section 23801(c).

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

c. Subpart F Income

For many years the foreign source earnings of a foreign subsidiary of a U.S. parent were not taxed in the U.S. until repatriated. In 1962 Congress added the Subpart F provisions to the Internal Revenue Code which attempted to limit the deferral of these foreign earnings.

Generally, if a CFC earns certain types of income that come under the purview of Subpart F, the earnings are taxed to the United States shareholder as a deemed dividend under Federal law.

IRC Section 952 defines types of income considered Subpart F income. The Subpart F income of a CFC is the sum of the following items.² (Other types of Subpart F income are defined in IRC Section 956 and 956A. These items of Subpart F income are not considered in determining the extent to which a CFC is included in a water's-edge combined report.³)

1. Income from Insurance of U.S. Risks
2. Foreign Base Company Income
3. International Boycott Income
4. Denied Foreign Tax Credit Income
5. Illegal Bribes and Kickbacks

Each type of income is discussed fully in **Chapter 9, Water's-Edge Manual**. For now it is sufficient to know that income meeting the definition of each of these categories is considered Subpart F income. Generally, the most common type of Subpart F income is Foreign Base Company Income.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

d. Water's-Edge Application

The treatment of Subpart F income in the water's-edge combined report is substantially different than the treatment for federal purposes. For federal purposes the income is treated as a deemed dividend to the U.S. shareholder. In the water's-edge combined report Subpart F income becomes part of a formula used to determine the CFC's includible income and factors. Therefore, deemed dividends reported for federal purposes must still be eliminated as a state adjustment, just as they would be for a worldwide combined report.

For purposes of a water's-edge return, the five general types of Subpart F income are considered in the computation of the ratio used to determine the CFC's income and factors includible in the combined report. For state purposes, the provisions of IRC Section 952(c) concerning recharacterizations of income, limitations and deficits in earnings and profits do not apply to the water's-edge inclusion ratio calculation.⁴

The formulae for calculating the CFC's income and factors are:

$$\begin{array}{l} \text{Income} \\ \text{Subpart F Income} \\ \text{Earnings \& Profits} \end{array} \quad \times \quad \begin{array}{l} \text{Total Net Income} \\ \text{(determined on a CA} \\ \text{tax accounting basis)} \end{array} \quad = \quad \text{Includible Income}$$

$$\begin{array}{l} \text{Factors} \\ \text{Subpart F Income} \\ \text{Earnings \& Profits} \end{array} \quad \times \quad \text{Factors} \quad = \quad \text{Includible Factors}$$

The regulations explain that the components of both the Subpart F income and E&P include both business and nonbusiness income. Once the fraction is determined, it is then applied separately to business income, nonbusiness income, interest expense subject to the offset, and other items which may need to be included in the appropriate areas of the combined report. The application of the fraction is not intended to change the character of business and nonbusiness income. CFCs with Subpart F income are only partially included in a water's-edge return. To determine the includible amounts of the CFC's total income and apportionment factors one must multiply these items by a fraction the numerator

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

of which is Subpart F for the current year as defined by IRC §952, and the denominator of which is E&P for the current year as defined by IRC §964.⁵

Example 1:

Corporation C has Subpart F income of \$30,000 for the year. Its earnings and profits for the year are \$100,000. The inclusion ratio to be used is computed as follows:

$$\frac{\text{Subpart Income } \$33,000}{\text{Total Earnings \& Profits } \$100,000} = 33\%$$

Amounts includible in the water's-edge combined report are as follows, assuming the amounts stated below:

Business income subject to apportionment:

$$\begin{aligned} \$120,000 \times 33\% &= \$39,600 \\ \text{Average Owned Property: } \$150,000 \times 33\% &= \$49,500 \\ \text{Rent to Capitalize: } \$30,000 \times 33\% &= \$9,900 \\ \text{Payroll: } \$60,000 \times 33\% &= \$19,800 \\ \text{Sales: } \$180,000 \times 33\% &= \$59,400 \end{aligned}$$

Example 2:

Corporation F has a ratio of Subpart F income to earnings and profits of 1/4. Both Subpart F income and earnings and profits include business and nonbusiness income. Corporation F has total income of \$1600, including net business income of \$1000 and nonbusiness dividends of \$600 allocable to its domicile in a foreign country. Net business income includes a deduction for interest expense of \$200. Corporation F has no interest income. Amounts for Corporation F includible in the water's-edge combined report are computed as follows:

Business income subject to apportionment:

$$\$1000 \times 1/4 = \$250$$

Nonbusiness dividends allocable outside California:

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

$$\$600 \times 1/4 = \$150$$

$$\text{Interest Expense: } \$200 \times 1/4 = \$50$$

If there are no earnings and profit for the current year, then none of the income and factors of the CFC are included in the water's-edge combined report. The fraction to determine the amount of total income and the factors cannot exceed one nor be less than zero.⁶

As a result of the above limitation, if Subpart F income for the year exceeds earnings and profits for the year, the ratio is deemed to be one and the entire income and apportionment factor amounts of the CFC will be included in the combined report. Because Subpart F income is always a positive number, when there is a deficit of earnings and profit for the year, the ratio will be deemed to be zero. None of the income or apportionment factors' amounts would be included in the combined report.

Application of these rules could result in inclusion of a CFC in a combined report if it has negative California adjusted net income but only if it has positive earnings and profit for the year.

For an explanation of how to determine earning and profits of the CFC, please refer to **Chapter 11, Water's-Edge Manual**.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

e. *Summary*

Any CFC with Subpart F income is partially included in the water's-edge combined report. As defined in IRC section 952, there are numerous types of subpart F income with Foreign Base Company Income being the most common.

The CFC's Subpart F Income is included in a formula used to calculate the portion of the income and factors included in the water's-edge combined report. Those amounts of income and the apportionment factors are determined by a fraction, the numerator of which is the subpart F income for the year and the denominator of which is the earnings and profit for the year. The fraction can not exceed one or be greater than zero.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Footnotes

1. CCR §25110(d)(2)(F)
2. IRC §952(a)
3. CCR §25110(d)(2)(F)(i)
4. See footnote 3, *supra*.
5. CCR §25110(d)(2)(F)(ii) & (iv)
6. CCR §25110(d)(2)(F)(ii)

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Section 2.8 Entities With Income Attributable To U.S. Sources

Contents:

- a. Introduction
- b. Deemed Subsidiaries
- c. Federal Rules For Taxing Foreign Corporations
- d. Water's-edge Application
- e. Summary

References:

R&TC §25110(a)(4) -- (formerly §25110(a)(5))
CCR §25110(d)(2)(G)

Training Objectives:

At the end of this lesson, the reader will be able to:

- 1. State the method of taxing effectively connected income (ECI) and non-ECI for federal purposes.
- 2. Explain how ECI is included in a water's-edge return.
- 3. Explain how U.S. source non-ECI is included in a water's-edge combined report.
- 4. Determine by which rule an entity is included in the water's-edge return if it meets more than one test.
- 5. Explain how the apportionment factors and income are determined for the water's-edge return.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

a. Introduction

This section will provide a brief overview of income attributable to U.S. sources, including ECI, and how it is included in a water's-edge combined report. For a detailed explanation of ECI and the U.S. sourcing rules, please refer to **Chapter 8, Water's-Edge Manual**.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

b. Deemed Subsidiaries

Foreign organized banks or corporations not meeting any other test for inclusion in a water's-edge combined report, must include their income attributable to U.S. sources, as determined by federal income tax laws, and their factors assignable to the U.S. under state apportionment rules in the combined report.¹

The deemed subsidiary rules apply to all foreign **banks** making a water's-edge election regardless of the percentage of their U.S. factors.

However, the deemed subsidiary rules apply to foreign **corporations** only if they have less than 20% U.S. factors. Remember foreign corporations with at least 20% U.S. factors must include all their income and factors in the water's-edge combined report (assuming, of course, that they are unitary).

While the U.S. source concepts will be discussed fully in **Chapter 8, Water's-Edge Manual**, it is appropriate here to introduce the general concept.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

c. Federal Rules For Taxing Foreign Corporations

Federal taxation of foreign corporations generally depends upon three items:

1. whether the entity is engaged in a United States trade or business,
2. whether its income is United States or foreign source, and
3. whether its income is "effectively connected" with the conduct of a United States trade or business.

Federal taxation of a foreign corporation's U.S. sourced income depends on whether that income is ECI or non-ECI. Whether an income item is ECI or non-ECI is a facts and circumstances question. Non-ECI that is "fixed or determinable, annual or periodical" (FDAP) income is subject to a flat rate of tax on **gross** income. Income, such as interest, rents and royalties, may often be categorized as FDAP.

A flat 30% rate is imposed on the gross amount of FDAP income with no allowance for deductions, and is enforced by a withholding tax imposed on the U.S. payors of such income. However, a treaty between the U.S. and the foreign corporation's country could provide a lower tax rate.² Non-ECI that is not considered to be FDAP is not subject to federal tax.

If the income is ECI, the tax is based upon net income (e.g. gross receipts less allowable deductions) and the rate is same as for a United States corporation.³

Example 1:

For federal purposes a foreign corporation derives \$100 in interest income from a shareholder loan and \$1,000 from ECI. In this example, the \$100 interest income is FDAP subject to federal tax at the 30% withholding tax rate. The \$1,000 from ECI is taxed at the regular corporate rate after allowable deductions.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

d. Water's-Edge Application

Income years beginning on or after January 1, 1992

Effective for income years beginning on or after January 1, 1992, the following rules apply to determine income includible in the combined report:

- ECI and U.S. source non-ECI that is business income under UDITPA is includible in the combined report⁴ (U.S. source non-ECI that is not business income under UDITPA is not includible.)
- United States treaty provisions that limit the application of the ECI provisions of the IRC do not apply.⁵

Income years beginning prior to January 1, 1992

The Federal rules regarding ECI and the sourcing of income (IRC Sections 861 through 865) were adopted **without** modification for purposes of determining the income includible in the water's-edge combined report. This includes following U.S. tax treaty rules which limit the taxation of ECI.⁶

Non-ECI is not included in the water's-edge combined report even though it may be U.S. source income for Federal purposes, and even though it would be considered business income under state rules.⁷

For all water's-edge years

To determine the amount of expenses that are attributable to gross U.S. income, the IRC rules relating to allocation and apportionment of expenses will be used.⁸

Once the appropriate income and expense items under the applicable federal rules are determined, consideration must still be given to the determination of California taxable income. The net income included in the combined report will be determined in accordance with the California Revenue and Taxation Code.⁹ For example, depreciation expense would be calculated using the method allowable for state purposes.

The United States located apportionment factors of the foreign corporation will be determined in accordance with Section 25120 of the California Revenue and

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Taxation Code and corresponding regulations as long as they are consistent with the determination of the U.S. located income.¹⁰ In other words, only the factors that relate to the includible income are considered in the combined report computation.

If a foreign bank or corporation which is not a California taxpayer has both Subpart F income and U.S. source income, the U.S. source income will be included in the water's-edge combined report under the U.S. source income / ECI rules. To the extent that such income is included in the water's-edge combined report under those rules, it should not be included again under the Subpart F partial inclusion rules.¹¹

Example 2:

Corporation F, a foreign corporation, has a branch office in California from which it sells goods to customers located in the U. S. The various products are manufactured by that corporation in the foreign country. For income year 1988 the U.S. Branch generated sales and related expenses of:

U.S. Gross Sales	\$1,000,000	
<u>U.S. Cost of Sales</u>	700,000	(Pursuant to Treas. Reg. §1.861-8
U.S. Source Income	300,000	

Excess funds generated by F's U.S. business activity were invested in publicly traded securities issued by domestic corporations. F plans to use these excess funds to expand its U.S. facilities within the next three years. During 1988 the branch office derives the following income from their investment:

U.S. Source Income Dividend	\$200,000
Income	
U.S. Investment Expense	<u>50,000</u>
Net Investment Income	\$150,000

For federal purposes, the dividends and interest received from these investments are not considered effectively connected with the conduct of its U.S. trade or business.

For California purposes, only the \$300,000 would be included in the combined report under Section 25110 of the California Revenue and Taxation Code,

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

subject to any other state income adjustments. (Remember that for income years beginning on or after January 1, 1992, the investment income would be included in the combined report, even if it were not considered ECI for federal purposes, if the income is business income under California rules.)

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

e. *Summary*

Foreign corporations with less than 20% U.S. factors and foreign banks must include their U.S. factors and income in the water's-edge combined report. The federal sourcing rules for income and expenses as detailed in IRC Sections 861 thru 865 are used to determine includible amounts of income and expense for California purposes. However, consideration must be still be given to the California taxable income. The U.S. located apportionment factors are determined in a manner consistent with the U.S. located income and in accordance with California Revenue and Taxation Code.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Footnotes

1. CCR §25110(d)(2)(G)
2. IRC §881
3. IRC §882
4. CCR §25110(d)(2)(G)(i)(I)
5. See footnote 4, *supra*.
6. CCR §25110(d)(2)(G)(ii)(I)
7. CCR §25110(d)(2)(G)(ii)(II)
8. CCR §25110(d)(2)(G)(iii)
9. CCR §25110(d)(2)(G)(iv)
10. CCR §25110(d)(2)(G)(vii)
11. CCR §25110(d)(2)(H)

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Section 2.9 Partnerships, Joint Ventures And Other Hybrid Entities

Contents:

- a. Introduction
- b. General Rule
- c. Federal and California Entity Classifications
 - 1. Pre-1997 Federal Law
 - 2. Post-1996 Federal Law
 - 3. California Treatment
- d. Partnerships and Entities Treated as Partnerships
 - 1. Partnerships Among Corporations
 - 2. Partnerships and California Combined Reporting
 - 3. Joint Ventures
 - 4. Foreign Hybrid Entities
- e. Water's-Edge Application
- f. Summary

References:

IRC §§701 - 706
IRC §761
IRC §1504
IRC §7701
R&TC §23038
CCR §23038(b)
CCR §25137-1

Training Objectives:

At the end of this lesson, the reader will be able to:

- 1. Explain the 1997 law changes affecting the classification of an entity as a corporation vs. a partnership.
- 2. State when a partnership is included in a water's-edge combined report.
- 3. Explain how a partnership is included in a water's-edge combined report.

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

-
4. Explain how a joint venture is taxed and included in a water's-edge combined report.
 5. Explain how an entity organized under foreign law is classified and when it must be included in a water's-edge combined report.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

a. Introduction

This section will cover the basic requirements for classification of an unincorporated organization as a corporation versus a partnership and the rules for inclusion of partnership income and factors into the water's-edge combined report.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

b. General Rule

The income and factors of any unincorporated organization which is treated as a partnership are includible in the water's-edge combined report if the following two criteria are met:

1. The corporate partner is included (or partially included) in the water's-edge combined report; and
2. The partnership activities and the taxpayer's activities constitute a unitary business under established standards, disregarding ownership requirements.

The taxpayer's share of partnership income and apportionment factors is included in the taxpayer's water's-edge combined report pursuant to the provisions of CCR §25137-1.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

c. Federal And California Entity Classifications

1. Pre-1997 Federal Law

For federal purposes prior to January 1, 1997, Treas. Regulation §301.7701-1(b) described certain categories or classes into which various organizations fall for purposes of taxation. These categories or classes included associations (which are taxable as corporations), partnerships, and trusts.¹ The basic characteristics of a corporation are identified in the regulation. Whether a particular organization should be classified as an association, partnership or trust must be determined by taking into account the presence or absence of each of those characteristics.²

The first two characteristics are (1) associates and (2) an objective to carry on business and divide the gains. If an organization has those two characteristics, then it will generally be classified as either an association or a partnership rather than as a trust. The remaining characteristics that are relevant in distinguishing between a partnership and an association are:

1. Continuity of life.
2. Centralization of management.
3. Limited liability.
4. Free transferability of interests.

If an unincorporated organization has more corporate characteristics than noncorporate characteristics (in other words, if it has at least 3 of the above 4 characteristics), then it will be treated as an association and taxed as a corporation. Otherwise, the organization will be treated as a partnership.³

An entity organized under foreign law cannot be classified for federal tax purposes solely on the basis of the label attached to the entity by the statute under which it is established. Instead, all foreign entities are to be considered "unincorporated organizations," for purposes of (former) §301.7701-2(a)(3) of the regulations.⁴ The applicable foreign statute and the entity's organization agreements must be examined to determine whether the corporate characteristics identified in Treas. Reg. §301.7701-2 are present. For example, the IRS ruled that a German GmbH owned by two wholly owned subsidiaries of a U.S. corporation was an association under Treas. Reg. § 301.7701-2.⁵ However, classification of a GmbH as an

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

association is not automatic; under German law, considerable flexibility is afforded in connection with the formation of a GmbH. Accordingly, it is possible that a particular GmbH may be classified as a partnership. Similar issues may occur with other types of foreign entities.

Although the same standards apply for the classification of foreign entities and unincorporated domestic entities, local law of the foreign jurisdiction must be used in determining the legal relationships among the members of a foreign organization against which the criteria of the regulation is being tested.

2. *Post-1996 Federal Law*

Effective as of January 1, 1997, the regulations under IRC §7701 were amended. The new regulations are commonly known as the “check-the-box” regulations because they allow the taxpayer to select how most unincorporated entities will be classified for tax purposes. Under the new regulations, it is no longer necessary to analyze the characteristics of an organization in order to determine its classification. Instead, the following basic rules are applied:

1. Business entities which are “per se” corporations are required to be taxed as corporations. Per se corporations include entities organized as corporations or joint-stock companies under a federal or state statute or taxable as corporations under another provision of the IRC; insurance companies; state-chartered banks; and certain foreign entities.⁶ The specific foreign entities that are treated as per se corporations are listed in Treas. Reg. §301.7701-2(b)(8).
2. Business entities that are not per se corporations are considered “eligible entities.” An eligible entity can elect its classification for federal tax purposes. An eligible entity with at least two members can elect to be classified either as an association (which will be treated as a corporation) or as a partnership. An eligible entity with a single owner can elect to be classified as an association (which will be treated as a corporation) or to be disregarded as an entity separate from its owner. If disregarded, then it will be treated as a sole proprietorship if owned by an individual, or as a branch or division if owned by a corporation.⁷
3. If an domestic eligible entity does not elect a classification, then it will default to classification as a partnership if it has two or more members, or will be disregarded as an entity separate from its owner if it has a single owner.⁸
4. If a foreign eligible entity does not elect a classification, it will default to

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

classification as a partnership if it has two or more members and at least one member does not have limited liability; an association if all members have limited liability; or will be disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.⁹

5. An eligible entity in existence prior to January 1, 1997 will generally continue to have the same classification that it did under the pre-1997 regulations unless and until it makes an election under the new regulations.¹⁰

Even though a “check-the-box” change in the classification of a business entity may be in form only, the tax consequences of the change will be the same as if the entity had actually gone through the steps to change its classification. Proposed treasury regulations have been issued to provide guidance regarding how the IRS will treat changes in classification.¹¹ For example, if an organization classified as an association elects to be classified as a partnership, the association will be deemed to liquidate and its shareholders will then be deemed to contribute the assets to the newly formed partnership. Likewise, if a partnership elects to be classified as an association, there will be a deemed contribution of assets to the association in exchange for stock, followed by a dissolution of the partnership in which the stock is distributed to the partners. To the extent that there is recognized gain or other tax consequences from the deemed transactions, those tax consequences will be respected.

Example 1:

Mega Corp, a U.S. Corporation, is a 75% owner of Eurobiz, a foreign entity which had been treated as a association. Eurobiz makes an election under Treas. Reg. §301.7701-3 to be classified as a partnership. The Eurobiz association is deemed to liquidate under the rules of IRC §331 and §336 (the liquidation would not qualify as a §332 tax-free liquidation because Mega Corp did not meet the 80% ownership threshold). Mega Corp is then deemed to have contributed its share of Eurobiz's assets and liabilities to the newly formed partnership. Eurobiz would recognize any §336 gain or loss from the distribution of its assets and Mega Corp would recognize any §331 gain or loss in its Eurobiz stock.

California implications: If Mega Corp had filed a worldwide combined report, then both the Eurobiz and Mega Corp gains would be included in the combined report (subject to any applicable intercompany transaction rules). If Mega Corp filed under a water's-edge election, Eurobiz's §336 gain could potentially be subpart F income, which would increase its partial inclusion percentage.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Example 2:

Assume the same facts as in Example 1, except that Mega Corp owns at least 80% of the Eurobiz stock. Because the deemed liquidation would now qualify under §332, neither Eurobiz nor Mega Corp would generally recognize any gain or loss. However, Mega Corp's nonrecognition of gain under §332 may be subject to IRC §367(b) restrictions (see Section 19.4, Water's-Edge Manual).

3. *California Treatment*

A. *Pre 1997:*

California did not conform to IRC §7701 or to Treas. Regs. §301.7701-1, -2, -3 or -4, but CCR §23038 provided rules for the classification of business entities that were similar to the pre-1997 federal treatment. Therefore, state classification of entities should generally be the same as the federal classification for income years beginning prior to January 1, 1997.

B. *On or after 1/1/97:*

In 1997, §23038 was amended to generally conform to the federal check-the-box election. The conformity is retroactive to January 1, 1997, which is the date that those rules became effective for federal purposes. As amended, §23038 provides that the classification of an eligible entity for California purposes must be the same as the federal classification.

An exception applies to certain existing eligible entities that were classified as an association for California purposes but not for federal purposes prior to 1/1/97 (this will primarily affect business trusts and single-member LLCs). An entity that falls within this exception will continue to be classified as an association *until* it makes a irrevocable California election to be classified the same as it is classified for federal purposes. During the time period that the entity's California classification is different from its federal classification, transactions involving that entity may be treated differently for state and federal purposes.

Other features of California's conformity to the check-the-box rules that you should be aware of include:

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

-
- 1 If an eligible entity (an entity which is not a "per se" corporation) is classified as an association, it will be taxable under Chapter 3 (the income tax) rather than Chapter 2 (the franchise tax).¹² This means that eligible entities classified as associations will not be subject to the minimum franchise tax. Also, interest income from U.S. government obligations and from obligations of California and its political subdivisions are exempt under the Chapter 3 income tax, but not under the Chapter 2 franchise tax. If an association is a taxpayer member of a combined reporting group that includes taxpayer corporations, the combined report will include some entities which are subject to the income tax and some entities which are subject to the franchise tax. If the unitary business income of the combined reporting group includes interest income which is exempt under the income tax, then the auditor will have to reverse the association's intrastate apportioned share of the exempt income out of its intrastate apportioned unitary business income.
 2. Tax credits attributable to a disregarded entity are limited. If the disregarded entity is owned by a corporation, then it will be treated as a branch and its tax credits or credit carryovers would normally be applied against the owner's tax liability. Under §23036(i) however, the credits may only be applied against the excess of the owning corporation's regular tax over what the owning corporation's tax would have been if the disregarded entity's income were not considered.
 3. Rev. & Tax Code §23038 and the regulations thereunder provide that the classification of an eligible business entity must be the same for California as for federal purposes, and a federal check-the-box election will be binding for California purposes. There is no provision for a California-only check-the-box election. In some situations, the classification of a foreign entity may be relevant for California purposes but not for federal purposes. (This is more likely to occur in a worldwide combined report, when foreign entities owned by an ultimate foreign parent are included in the combined report but do not affect the federal tax liability or information reporting requirements for any U.S. taxpayer.) Because the classification is not relevant for federal purposes, the taxpayer would not generally make a federal check-the-box election. Therefore, such an entity would be classified under the default rules (or transitional rules, depending on the situation) for California purposes. The taxpayer would not be entitled to change its classification for California without first changing its classification for federal purposes.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

d. Partnerships And Entities Treated As Partnerships

The term "partnership" includes "a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of [the Code], a corporation or trust or estate...."¹³ As discussed in the preceding section of this chapter, classification as a partnership is based upon the organization's characteristics or pursuant to federal check-the-box regulations. Whether a joint enterprise is a partnership under common law or under state partnership statutes is not determinative of its status for income tax purposes. Therefore, an enterprise may be classified as a partnership for tax purposes even though it is not, or could not be, a partnership under a state partnership statute. Conversely, the fact that a joint enterprise is a partnership under state law is not dispositive of its classification for income tax purposes.

Once an entity is determined to be a partnership, its activities are subject to the partnership provisions of Subchapter K of the Code. A partnership, as such, is not subject to income tax, but rather, each partner is liable for the tax on their portion of the partnership's income.¹⁴ Thus, for tax purposes, the partnership functions as a conduit, funneling income, gains, losses, deductions or credits to the individual partners who account for these items on their own income tax returns.¹⁵ A partnership is required to compute separately its "taxable income,"¹⁶ and to complete the statutory structure, each partner is then required to include in gross income its distributive share of partnership items, including income, gain, loss, deductions, and credits.¹⁷ The Supreme Court has described the above process as follows:

For [the purpose of calculating partnership income], the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners. Once its income is ascertained and reported, its existence may be disregarded since each partner must pay a tax on a portion of the total income as if the partnership were merely an agent or conduit through which the income passed.¹⁸

1. Partnerships Among Corporations

A partnership formed among two or more corporations can create significant tax advantages. For example, if two corporations (the "parents") desire to jointly acquire and operate a business, each can utilize a wholly owned subsidiary to serve as a partner in a partnership formed to acquire and conduct the business. By using subsidiaries to serve as partners, each parent can obtain limited liability with respect to partnership debts. Moreover, the partnership's management structure

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

can be tailored to suit the needs of the venture. From a tax perspective, each subsidiary includes its distributive share of partnership income on its return¹⁹ and each may join its parent's consolidated return.²⁰ By contrast, if a single, jointly owned corporation is used (instead of a partnership) as the joint venture vehicle, the venture corporation cannot be included on the consolidated return of either parent.²¹ Accordingly, the venture corporation will be taxed directly on its income.

Partnerships among related corporations, including members of an affiliated group of corporations filing a consolidated return, are generally respected as partnerships for federal income tax purposes.²² Accordingly, since a partnership cannot be a member of the affiliated group,²³ transactions between the partnership and members of the affiliated group are not governed by the consolidated return rules. However, a corporate partner who is a member of a consolidated group during the group's consolidated return year does include its distributive share of the partnership's items in the consolidated return.

A partner's distributive share of partnership items is includible on the corporate income tax return in the corporation's tax year in which the partnership tax year ends.²⁴ If a corporate partner becomes a member of a consolidated group during the group's consolidated return year, the IRS is of the view that the partnership's income must be allocated between the consolidated return and the separate return pursuant to Treas. Reg. §1.1502-76(b)(4),²⁵ even though the partnership's year does not end until after the corporate partner becomes a member of the consolidated group.

2. Partnerships And California Combined Reporting

For combined reporting purposes, the California Franchise Tax Board has issued a comprehensive regulation²⁶ for apportionment and allocation of partnership income in unitary situations where a corporation has an interest in a partnership and one or both have income from sources within and without the State. In essence the regulation provides that a corporation must file a combined report with a partnership even though it has less than a 50 percent interest in the partnership if the corporation otherwise has a unitary relationship with the partnership. The corporation must include both its share of the partnership income in the combined report and its share of the partnership's factors in the combined apportionment factors. The rationale behind the inclusion of partnership items in the combined report is really due to the "aggregate" or "conduit" view of partnerships. That is, a partnership is simply an aggregation of individuals, each of whom should be treated as the owner of a direct undivided interest in partnership assets and operations. Based upon the "aggregate" theory, the partnership activities are in reality considered to be the partner's activities to the extent of the partner's capital interest in the partnership. Thus, if the corporation has 30% interest in the partnership, 30

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

percent of the partnership income would be included in the combined report and 30 percent of the partnership factors would be used in the apportionment formula.

Unitary partnership items are included in the water's-edge combined report in the same manner in which partnership items are reported on a worldwide combined report. The test is whether or not the **partner** is eligible to be included in the water's-edge combined report.

- If the partner is 100% included in a water's-edge combined report, then its share of the unitary partnership's income and factors must be included. The location of the partnership activities is irrelevant. Even if the partnership operates entirely outside of the U.S., the partner's distributive share of income and factors is included in the partner's water's-edge combined report.
- If the partner is excluded from the combined report, then its share of the partnership income and factors are also excluded. Keep in mind, however, that if a partnership has U.S. source income, then the partner's distributive share of that income will also be U.S. source income. This may result in the partner being included (or partially included) in the water's-edge combined report, which would in turn require that the partnership income and factors be included.

3. Joint Ventures

A joint venture that carries on a business, financial operation, or venture is taxable as a partnership under the regulations unless it constitutes a trust, an estate, or an association.²⁷ As such, if the "joint venture" activities and the taxpayer's activities constitute a unitary business under established standards, disregarding ownership requirements, the taxpayer's share of "joint venture" income and apportionment factors is included in the taxpayer's combined report. In *Appeal of Pittsburgh-Des Moines Steel Company*, California State Board of Equalization, June 21, 1983, the taxpayer corporation was engaged in a unitary business involving various aspects of the steel business. The corporation had a 50% interest in a joint venture with a real-estate operator; the joint venture was formed to build and lease two office buildings in California. The State Board of Equalization held that the corporation's share of the income and apportionment factors of the joint venture should be included in the corporation's combined report.²⁸

4. Foreign Hybrid Entities

As stated previously in this chapter, a business organization established under foreign law may have a different classification for federal or state tax purposes than it has under foreign local law. For example, an entity may be considered an

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

association under foreign law, but be classified as a partnership for federal tax purposes. Such entities are commonly called "hybrid" entities. If the taxpayer is affiliated with a material hybrid entity, the auditor should verify that the hybrid entity is classified correctly for California tax purposes (under either pre-1997 law or the check-the-box rules, whichever is applicable). Correct tax classification may affect the way that transactions with that entity are treated, and even whether or not that entity is reflected in the water's-edge combined report. For example, a foreign association with a U.S. parent may be excluded from the water's-edge combined report, but if the entity is classified as a foreign partnership, then the U.S. partner's distributive share of the income and factors would be included in the water's-edge combined report.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

e. *Water's-Edge Application*

The inclusion of partnership items in the water's-edge combined return does not result in different implications than those which already result with their inclusion in the worldwide combined report.

Audit Tip: Due to the difference of including the distributive share of income and factors of a foreign partnership owned by a US entity and excluding (generally) the income and factors of a foreign subsidiary, it may be beneficial to verify the correct classification of material foreign entities for California tax purposes. This may be done by first reviewing the foreign entity's organization documents and foreign law in order to determine what type of foreign entity you are dealing with. Then, apply the provisions of Treas. Reg. §301.7701-1 through -4 and R&TC §23038 applicable to the income years in question to determine the entity's correct classification for income tax purposes. This is especially relevant for any entity organized under a "unique" foreign statute (i.e. foreign statute not comparable to US law), or an entity not identified as a "per se" corporation in Treas. Reg. §301.7701-2(b).

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

f. Summary

If a corporation included in the water's-edge combined return (based upon criteria as outlined in Section 2.1, Water's-Edge Manual) is a partner in a partnership (as determined under rules defined by federal tax law and followed by California), and the partnership's activities are unitary with the corporation's activities (disregarding ownership requirements), then the corporation's share of the partnership's trade or business is combined with the corporation's trade or business. The corporation's distributive share of the partnership's income and factors must be included in the water's-edge combined report. The location of the partnership activities is not relevant.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Footnotes

1. Treas. Reg. §301.7701-2 through §301.7701-4
2. Treas. Reg. §301.7701-2
3. Treas. Reg. §301.7701-2(a)(3)
4. Rev. Rul. 88-8, 1988-1 C.B. 403 (IRS)
5. Rev. Rul. 77-214, 1977-1 C.B. 408 (IRS); Rev. Rul. 93-4, 1993-3 IRB 5 (IRS)
6. Treas. Reg. §301.7701-3(a)
7. Treas. Reg. §301.7701-3(a)
8. Treas. Reg. §301.7701-3(b)(1)
9. Treas. Reg. §301.7701-3(b)(2)
10. Treas. Reg. §301.7701-3(b)(3)
11. Proposed Treas. Reg. §302.7701-3(g)
12. R&TC 23038(b)(2)(A)
13. IRC §761(a)
14. IRC §701
15. IRC §702 and Treas. Reg. §1.702-1(a,b)
16. IRC §703(a)
17. IRC §702
18. United States v. Basye, 410 US 441,448 (1973)
19. IRC §702
20. IRC §1504
21. This assumes that one of the parents does not own 80 percent or more of the vote and value of the venture corporation's stock. IRC §1504
22. Rev. Rul. 75-19, 1975-1 C.B. 382 (IRS)
23. IRC §1504(a)(1)(A)
24. IRC §706(a)
25. General Counsel Mem. 39292 (April 30, 1984); Technical Advice Mem. 8442001 (May 14, 1984)
26. CCR §25137-1
27. Treas. Reg. §301.7701-3(a); see §761(a) for a statutory endorsement of this definition.
28. Also, see Appeal of Williamette Industries, Inc., State Board of Equalization, June 17, 1987

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

Section 2.10 Audit Procedures

Contents:

- a. Introduction
- b. Entities Included in a Water's-edge Combined Report
- c. Audit Procedures
- d. Summary

Training Objectives:

At the end of this lesson, the reader will be able to:

- 1. List the entities included in the water's-edge combined report
- 2. List audit steps which need to be taken for both worldwide audits and water's-edge audits
- 3. List 2 audit steps to determine if an entity is eligible for inclusion in a consolidated 1120
- 4. List 3 audit steps to determine if a FSC exists and meets the federal requirements
- 5. List the audit steps to determine if an entity has greater than 20% activity in the U.S.
- 6. List 4 audit steps to determine the existence of any domestic corporations owned greater than 50%
- 7. List 3 audit steps to determine if a CFC meets the requirements of an export trade corporation
- 8. List 9 audit steps to determine if a CFC has Subpart F income
- 9. List 6 audit steps to determine if an entity has effectively connected income

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

a. *Introduction*

As stated at the beginning of this chapter, there is a two-fold test for companies to be included in a water's-edge combined report. The two tests are:

1. An entity must be unitary with the California taxpayer AND
2. An entity must meet one of the 5 tests for 100% inclusion **or** one of the 2 tests for partial inclusion in the water's-edge combined report.

The objective of this section is to address the criteria that must be met for inclusion in a water's-edge report. This section will discuss possible audit procedures to give consideration to during a water's-edge audit to discern whether all companies to be included in the water's-edge combined report have been included or if an entity has been improperly included. It should be noted some of the audit procedures for determining if one of the water's-edge tests has been met are similar to the procedures used to determine if a combined report is warranted.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

b. Entities Included In Water's-Edge Combined Report

Let's review the types of entities that must be included in the water's-edge combined report if they are unitary and meet one the 5 tests for 100% inclusion or one of the 2 tests for partial inclusion:

Companies Included 100%

1. Banks or corporations eligible for inclusion in a federal consolidated tax return (IRC 1504), except for corporations making an IRC §936 election (possessions corporation). (**Note: this criteria for inclusion was repealed effective January 1, 1996**).
2. Foreign sales corporations (FSCs) and domestic international sales corporations (DISC) under IRC 921-927.
3. Corporations but not banks, with 20% or more average apportionment factors within the U.S. regardless of where incorporated.
4. Banks and corporations incorporated in the U.S. and owned and controlled more than 50%, except for corporations making an IRC §936 election.
5. Export trade corporations under IRC 971.

Companies Partially Included

1. Controlled foreign corporations (CFCs) if they have Subpart F income defined in IRC §952. These companies are included at the percentage their Subpart F income bears to their total earnings and profit for the year.
2. Foreign banks and corporations not meeting any of the requirements to be included 100% are included to the extent they have income which is "effectively connected" (ECI) or which is treated as being effectively connected with a U.S. trade or business. (IRC 882). For income years beginning on or after January 1, 1992, such entities must also include any U.S. source non-ECI that is considered business income under R&TC §25120.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

c. Audit Procedures

As with a worldwide audit, one of the first steps in commencing a water's-edge audit should be to become familiar with the taxpayer's affiliated group. The auditor should identify the existence of all affiliated corporations, their percentage of ownership and whether each entity is a domestic or foreign corporation.

Some useful sources are:

Charts showing the organizational structure of the group

- Annual reports
- SEC 10Ks and 20Fs
- Consolidated federal 1120's
- Consolidated financial statements
- Articles of incorporation to check where entities are incorporated
- Prior audit reports
- Published reference materials (Moody's, Directory of Corporate Affiliates, etc.)
- Domestic Disclosure Spreadsheet (See Chapter 5, Water's-Edge Manual)
- Federal Form 851 Affiliation schedule attached to federal 1120 identifies the affiliates included in the consolidated 1120 and their ownership percentages
- Federal form 5471 identifies related foreign subsidiaries and their ownership percentages.
- Federal form 5472 identifies every foreign corporation that is engaged in a trade or business in the U.S., and foreign affiliates of domestic corporations owned or controlled 25% or more by a foreign person if the foreign affiliate had transactions with the domestic corporation during its taxable year.
- Lexis/Nexis company files

As with a worldwide audit, the auditor should check the status of a federal audit to determine if the IRS is investigating or has already made a determination on an item that could effect the California return.

Once the above steps have been taken for the identification of affiliates, consideration should be given to the following for each of the water's-edge tests:

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

A. Consolidated 1120

1. Compare Federal Schedule 851 with Companies Included in California Return
2. Check for Canadian & Mexican Subsidiaries
 - a. Review Federal Schedule 851
 - b. Review Federal 5471
 - c. Review Articles of Incorporation
 - d. Research laws of country of incorporation
 - e. Review 10K's

B. FSC and DISC

1. Obtain & review 1120 FSC
 - a. Determine its ownership structure
 - b. Review the return to ensure that all FSC income has been included in the combined report
2. Review Consolidated Federal Schedule M-1 and reconcile to Annual Reports or Financial Statements
3. Check for the existence of a DISC

C. Greater than 20% Activity in the U.S.

1. Review 1120F or 1120 return
 - a. Determine the entities trade or business
 - b. Determine where it has an office or place of business
 - c. Is the taxpayer claiming a treaty-based exemption for federal purposes for income years beginning on or after January 1, 1992? California does not follow the treaty provisions that limit federal ECI for such years. The taxpayer may not have a permanent establishment for treaty purposes, but the corporation's presence in the U.S. may include property, payroll, or sales.
2. Review Financial Statements. Check for comments about offices or sales activities by geographic location.
3. Obtain breakdown by location of property, payroll, sales. When there is a geographical breakdown of property and sales in the annual report, request the detail on an entity by entity basis.

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

-
4. Review General Ledger and Trial Balance. Look for intercompany transactions and sales to unrelated third parties in the U.S.
 5. Review sales invoices. Look for unrelated third party sales in the U.S.
 6. Determine if the foreign corporation filed returns in any states. Obtain copies of the other state returns.
 7. Obtain copies of fixed assets ledgers by entity.
 8. Ask the taxpayer for reports on inventory by location if you believe there may be inventory in the U.S., such as a taxpayer operating in a foreign trade zone. Determine whether the entity or any of its affiliates have any activity in a foreign trade zone. Such activity could include property, payroll, and sales in the U.S.
 9. Request U.S. payroll reports for U.S. source payroll.

D. Domestic Corporations Owned Greater than 50%

1. Obtain all unconsolidated Federal 1120s
 - a. Check ownership
 - b. Check business activity
2. Reconcile with organizational chart
3. Review Annual Reports. financial statements
4. Review joint ventures
 - a. Is ownership/control greater than 50%?
 - b. Is the venture in corporate form or a partnership? If in partnership form, the unitary activities should be included in the combined report regardless of ownership (pursuant to CCR §25137-1).

E. Export Trade Corporations

1. Review 5471
 - a. When was it organized and qualified as an export trade corporation?
 - b. What type of trade or business is the CFC engaged in?
2. Review Certified Financial Statements for current year and 3 prior years and foregoing years
 - a. Identify types of income
 - b. Determine sources of income and related expenses
3. Review Transactions with parent company and affiliates

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

F. Subpart F Income

1. Review Federal Form 5471
 - a. Where is the CFC incorporated?
 - b. What type of trade or business is the CFC engaged in?
2. Review Certified Financial Statements of the CFC
3. Secure the CFC's tax package
 - a. What type of income did the CFC earn?
 - b. What type of expenses did the CFC incur?
4. Obtain CFC's income analysis by country
5. Analyze U.S. parents' intercompany account for reimbursements made on behalf of the CFC
6. Analyze the effective tax rate in the CFC's country of incorporation
7. Reconcile CFC's sales to reported sales to country of incorporation
8. Reconcile with parent's organizational chart or listing and foreign investment account

G. Effectively Connected Income

1. Review Federal Form 1120F
 - a. What is the status of the foreign corporation?
 - b. What is its trade or business?
 - c. What countries are encompassed in its trade or business?
 - d. Determine if and where it has an office or fixed place of business in the U.S.
 - e. What types of income are reported or reportable?
 - f. Check for ECI reported on Form 1120F, Schedule II.
 - g. Check items deemed non-effectively connected, reported on Form 1120F, Schedule I
 - h. Review Schedule M-1 detail to identify non-ECI
 - i. Review U.S. affiliates intercompany transaction detail for payments made to the foreign affiliate (for years beginning on or after January 1, 1992, the foreign affiliate should be included in the combined report if the payments received from the U.S. affiliate constitute U.S. source income under the IRC).
2. Analyze balance sheet items to reconcile effectively connected and non-effectively connected income with the U.S. trade or business
3. Review financial statements

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

-
4. Analyze expenses attributed to the U.S. business activities
 5. Has the foreign entity sold U.S. real property? (Federal Form 8288, U.S. Withholding for Dispositions by Foreign Persons of U.S. Real Property Interests)
 6. Did the foreign entity have income subject to withholding? (Federal Form 1042S, Foreign Person's U.S. Source Income Subject to Withholding)

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Water's Edge Manual

Rev.: September 2001

d. Summary

The preliminary steps for a water's-edge audit are similar to those necessary for a worldwide audit to become familiar with the affiliated group. However, these must be expanded to determine if an entity meets any of the tests for inclusion in a water's-edge combined report.